

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply to:
CC:TE/GE:EO2 PLR-118238-02
Date:
July 29, 2002

LEGEND

Trust =

State =

Plan =

Agency =

Division =

Agency B =

Statute A =

Statute B =

Statute C =

Statute D =

Statute E =

Statute F =

Statute G =

Statute H =

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\$x =

y =

Dear :

This is in reply to a letter dated March 25, 2002, requesting a ruling that Trust is an integral part of State for purposes of federal income tax and that Trust is not required to file a federal income tax return.

FACTS

State enacted Statute A to establish Plan to provide medical benefits for retired state employees. An individual is generally eligible to participate in Plan if he or she is employed by State or by a State or local governmental body that participates in one of multiple State pension plans named in Plan. Virtually all of the participants in Plan are state employees, public school teachers or the employees of local governments in State. A participant in Plan is entitled to reimbursement for post retirement expenses that constitute medical care as defined in § 213(d) of the Internal Revenue Code.

Trust was created for the purpose of holding and investing amounts contributed to Plan. According to the document creating Trust, the State, acting through the Agency, intends that Trust will be an integral part of the State and exempt from federal income tax. Trust is funded by employer contributions and investment earnings. Voluntary employee contributions are not permitted. However, employers are permitted to fund their contributions through employer-mandated reductions in employee compensation. Contributions are credited to separate recordkeeping accounts established for each participant. Individuals can direct the investment of the amounts credited to their accounts among different investment options. In addition, Agency is authorized by Statute A to charge participating employers a fee, not to exceed \$x, to pay for the initial costs of establishing Plan.

The final authority in all matters pertaining to the administration of Plan is Agency, the State retirement system. Agency administers pension funds providing retirement coverage for approximately y State employees and beneficiaries. Agency is an integral part of State. See Statutes B, C, D, E, F, G and H.

Trust is governed by the same board of trustees who serve as Agency's board of directors. The management of the various investment funds available to participants of Plan is supervised by Agency B. Agency B is a state agency created by the Constitution of State. Agency B is responsible for administering and directing the investment of state funds. The daily operations of Trust are carried out by employees of Agency. Upon the termination of Trust, after all payments to or on behalf of the

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participants and beneficiaries have been made, and any final administrative expenses of Trust have been paid, any amounts remaining revert to the State or the participating State government employers. See Statute A.

LAW & ANALYSIS

1. Is Trust an integral part of State?

Generally, if income is earned by an enterprise that is an integral part of a state or political subdivision of a state, that income is not taxable in the absence of specific statutory authorization to tax that income. See Rev. Rul. 87-2, 1987-1 C.B. 18; Rev. Rul. 71-131, 1971-1 C.B. 28; Rev. Rul. 71-132, 1971-1 C.B. 29.

In Maryland Savings-Share Insurance Corp. v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970) (MSSIC), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan associations. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim on intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the Supreme Court reversed the lower court on other grounds, it agreed with the lower court's analysis of the instrumentality and section 115 issues.

In State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the court held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under section 11(a). The court's opinion is internally inconsistent because it concludes that MET qualifies as a political subdivision of the State of Michigan. (Id. at 825), that MET is "in a broad sense" a municipal corporation (Id. at 826), and that MET is in any event an integral part of the State of Michigan (Id. at 829). Moreover, the court's reliance on the factors listed in Rev. Rul. 57-128, 1957-1 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from a state. The factors in the revenue ruling do not determine whether an enterprise is considered to be a separate entity or an integral part of a state.

Nevertheless, in determining whether an enterprise is an integral part of a state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

The control State exercises over Trust is substantial. Trust was created through state legislation. See Statute A. The charter document by which Trust was created

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provides that Trust was intended to be an integral part of State. Trust's trustees are the board of directors of Agency, an integral part of State. The duties of the board members are set forth in state statute. See Statute H. The board members are subject to the state statute that regulates the removal of board members from administrative boards and agencies. See Statute B. The employees of Agency who carry out the daily operations of Trust, the administrative staff of the board, and Trust's investment managers are all state employees. The financial contributions made by State to Trust are also substantial. As their employer, State pays the wages of the state employees of Agency who carry out the daily operations of Trust and the employees of Agency B who supervise the investment activities of Trust. As a public employer State contributes to the Plan retirement fund on behalf of its employees and may also be required to pay for its share of the initial costs of establishing Plan. Accordingly, Trust is an integral part of State.

II Is Trust required to file a federal income tax return?

Because Trust is an integral part of State, Trust is not required to file an annual federal income tax return.

Except as specifically provided otherwise, no opinion is expressed on the federal tax consequences of any particular transaction.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

Sincerely,

Elizabeth Purcell, Chief
Exempt Organizations
Branch 2
Division Counsel/Associate
Chief Counsel
(Tax Exempt and Government
Entities)

Enclosures;

CC:

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